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AAM **Company Profile**

Firm Notes Increased Demand for Customized Bundling of Services

—Exclusive Interview with AAM's CIO, Reed J. Nuttall—

AAM has seen steady growth over the last few years. The Chicago-based insurance asset manager added $600 million in new mandates in 2006, bringing total AUM to $15.2 billion as of year-end. When IFI last spoke with AAM in July of 2006, Joel Cramer, Director of Sales and Marketing, indicated that AAM's tax planning and related optimization services were garnering significant attention from potential clients. Tax modeling, however, is only one of the services that Cramer sees as being an integral part of the trend towards a bundled service approach to the management of insurers' investment portfolios.

AAM formed a partnership with DFA Capital Management (DFA) in February 2007. AAM now licenses DFA's enterprise risk management software, ADVISE, as part of a strategic move to offer more services to insurers, says Cramer. "There is a continued trend toward more bundling of services that I see on the new business front for P&C clients," Cramer said. He noted that AAM is interested in providing services that support the investment management process, "from outsourced investment accounting to quantitative modeling and enterprise risk management."

IFI recently spoke with **Reed Nuttall**, AAM's Chief Investment Officer, and **Joel Cramer** about the current investment outlook for insurers amid the turmoil in the subprime mortgage market.

IFI: What impact has the crisis in the subprime mortgage market had on your investment strategies?
Nuttall: Over the last two to three years, AAM felt that subprime was overdone, and we avoided that sector of the market, so we have not been adversely affected by recent defaults. Our analysts and credit teams have weathered a number of cycles and that experience helps us to keep our wits about us and to pick the right securities in a market of increasing volatility. As part of our overall strategy, we favor "AAA" rated structured products, which include mortgage-backed securities (MBS), asset-backed securities (ABS), and corporate mortgage-backed securities (CMBS). We think that these sectors offer very strong risk/reward characteristics and are a good way for our clients to improve the overall credit quality of their portfolios, while at the same time maintaining the book income that they need. Our portfolios tend to be overweighted toward ABS and CMBS.

IFI: What investment strategies would AAM recommend for life clients compared with P&C clients?
Nuttall: Our life insurance clients generally need book income and stability of cash flows, so we focus on asset types that provide stable income and additional yield. In addition to core holdings in Corporate bonds and MBS, taxable municipal bonds have been a strong asset class that add diversity to portfolios. We also favor some Ginnie Mae project loans. Life insurance companies tend to own a higher percentage of corporates. The market for corporates has been fair but not extremely attractive, so we use alternative asset classes to fund liabilities for our insurance clients, which include CMBS and ABS.

Our P&C clients can take advantage of tax-exempt municipal bonds. Tax-exempt municipal bonds with 2 - 5 year maturity are very attractive right now, while longer maturities are historically expensive versus taxable alternatives.

IFI: What distinguishes the way AAM manages insurers' portfolios?
Nuttall: Our focus on security selection and sector rotation with limited turnover generally lends itself to the insurance industry. A big issue with public insurance companies right now is the concept of "other than temporary impairment" (OTTI). If insurance companies take losses from bonds that are being sold as an implementation of an investment strategy, some auditors believe that demonstrates an inability to hold the security to maturity, which would then require the company to write down all securities with market values below cost to the current market price. Our strategy is to buy securities that may offer more yield and are a better strategic fit for an insurance company, but we may not buy them with an eye towards trading them in the near future. We have worked with a number of publicly-traded insurance companies by managing the risk associated with impaired bonds and reducing the amount of turnover that they have in the portfolio.

IFI: Are insurers showing an increased appetite for specialty fixed income assets, such as private placement, high yield, or emerging market debt?
Nuttall: Our life company clients demand yield with reasonable risk parameters; however, private placements have not been attractive compared to public markets. We have not seen a significant demand for high yield – certainly as spreads become tighter, we've seen people working to try and get out of that sector.

Cramer: People are looking for other ideas, and they are evaluating high yield. Our view is that high yield has had such a good run for several years that we may now be at the top of the market; we don't really think high yield is attractive right now. We don't offer emerging market debt, but it's a similar story there – emerging market debt has had such a good run for several years that a lot of people are hesitant to put new money in.

IFI: Have you seen significant growth in demand for private equity, hedge funds, or other alternative investments?
Cramer: The larger life and P&C companies are going into limited partnership vehicles with private equity and hedge funds as diversification mechanisms.

Nuttall: That's right. Many of the smaller insurance companies are certainly considering private equity or hedge funds, but there are some risks out there associated with investing in private equity and hedge funds. Finding the right hedge fund can place a strain on income and resources, and a lot of the smaller insurance companies do not necessarily need that level of diversification.

IFI: When the subprime crisis subsides, who is going to be left in the subprime lending market?
Nuttall: We're going to see a continued fallout. Delinquencies will get higher and will be followed by more defaults in the future. More firms will get out of the business, and we will be left with a few of the players that were rational to begin with and understand the business. Those firms should be able to weather the storm just fine, and I'm sure that they'll be writing subprime loans in the future, albeit with higher credit standards. ■

—Reed J. Nuttall, CFA, is a principal and Chief Investment Officer of AAM.

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